PROPOSED REGULATIONS FOR EGYPTIAN LIQUIDITY FACILITY

EGYPT FINANCIAL SERVICES PROJECT
TECHNICAL REPORT #59

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List of Acronyms

CEO	Chief Executive officer
CLO	Chief Lending Officer
CFO	Chief Financial Officer
EFS	Egypt Financial Services
IT	information Technology
IVS	International Valuation Standards
MFA	Mortgage Finance Authority
URAR	uniform Residential Appraisal Report
USPAP	Uniform Standards of Professional Appraisal Practice

Executive Summary

The Egyptian Liquidity Facility (the Facility) is to be established to provide additional funding for primary mortgage lenders, both mortgage finance companies and commercial banks which make mortgage loans. Initial capital is to be provided by international donors, and ownership will include the Central Bank of Egypt and other stakeholders, primarily including primary mortgage lenders who will borrow funds from, or sell loans to, the Facility. Technical assistance has been provided so far for the drafting of a business plan and a charter and by-laws. Initially, the Facility will help fund the mortgage market by providing borrowings, secured by mortgage loans, to primary mortgage lenders. Eventually, the Facility will further fund the mortgage market by creating and managing a secondary mortgage market, by buying loans from primary mortgage lenders and issuing bonds secured by these mortgage loans.

The proposed regulations presented herein are intended as a basis for the role of Mortgage Finance Authority (MFA) as the primary regulator of the Facility. Regulations were based on "best practices" used in regulating secondary mortgage market entities in the U.S. as well as those of smaller and newer venues. The structure of the regulations includes three major areas: corporate governance, capital adequacy, and safety and soundness.

Introduction

The Egyptian Liquidity Facility (the Facility) has been authorized and established to provide funding for primary mortgage lenders, either mortgage finance companies or commercial banks, which make mortgage loans. The purpose of this regulation is to set out guidelines and requirements for the Facility to ensure that it operates in a safe and sound manner while fulfilling its role to support primary mortgage lenders. The Mortgage Finance Authority (MFA), in its role as regulator of the Facility, will ensure that operations of the Facility are within safe and sound guidelines and requirements, so that the interests of shareholders, donor organizations, primary mortgage lenders, and other stakeholders are preserved. The ultimate responsibility for the policies, operations, and viability of the Facility lies with its Board of Directors.

Throughout this regulation, the term “the Facility” additionally includes any organization providing similar support to primary mortgage lenders. Such organizations include any subsidiary of the Facility; any special purpose vehicle for financing; any successor organization; and any parallel or other separate organization. All such organizations, except the Central Bank and commercial banks or affiliates regulated by the Central Bank, are subject to regulation by MFA.

Definitions:

Primary mortgage lender is defined as a mortgage finance company or bank or other authorized financial institution that makes mortgage loans directly to owners of real estate.

Secondary mortgage market is defined as those financial institutions and other organizations which purchase and sell mortgage loans, including the issuing of bonds or other instruments which are secured by mortgage loans.

Egyptian Liquidity Facility (the Facility) has been authorized and established as a lender of liquid funds to mortgage lenders and to eventually be a key organization in establishing a secondary mortgage market to provide additional liquid funds to mortgage lenders. The Facility will not be a primary mortgage lender.

Borrowing, whether in singular or plural, is defined herein as any loan made or renewed to a primary mortgage lender by the Facility. This term distinguishes this type of lending from mortgage lending by primary mortgage lenders to citizens.

Phase I of Facility operations is defined as the beginning period, during which sources of funds will primarily include capital, donor grants and loans, and other loans from banks and other financial sources. Primary business operations will be the lending of funds to mortgage finance companies and to banks making mortgage loans, typically secured by assignments of mortgage loans.

Phase II is defined as the period of operations during which the Facility will provide funds to primary lenders additionally by purchasing mortgage loans from them and then packaging those loans to secure bonds to issue on the securities market. This phase will be more complex and require greater risk management for increased market and operational risks. This regulation addresses some, but not all, issues which will emerge during Phase II.

Section I Corporate Governance

A. Scope and Purpose

This section of this regulation is intended to set out responsibilities for the Board of Directors (Board) and senior management of the Facility and to require or recommend various established means for fulfilling those responsibilities. These regulations are intended to use best practices for corporate governance as internationally established and also to conform with Egyptian legal principles.

B. General

The Board of the Facility is generally responsible to shareholders and other stakeholders for all aspects of the operations and performance of the Facility. The Board will direct and guide the Facility primarily through the appointment and oversight of competent senior management, approval of strategic corporate plans and budgets, the establishment of adequate policies and procedures, and the making of decisions in material areas of Facility operations.

As a part of these responsibilities, the Board will also monitor performance of the Facility through reports from 1) management at regular and special Board meetings, 2) the internal auditor, 3) external auditor(s), 4) MFA examinations and other regulatory activities, and 5) such other special inspections, investigations, or studies that the Board may commission.

See also the Safety and Soundness section of these regulations for more specific guidelines and recommendations.

C. Composition of Board of Directors

Membership of the Board will be appointed or elected according to founding documents and by-laws, including representatives from primary mortgage lenders.

Membership of the Board will also include outside directors with specialized expertise in such relevant areas as accounting, auditing, and law. From the beginning of Phase II operations, at least one director must have significant experience in capital markets or secondary mortgage markets.

D. Committees

The Board may, from time to time, appoint committees to serve specific functions and/or to research and report on a specific emerging issue important to the operation of the Facility. Such committees may be delegated limited authority to act on behalf of the Board on specific functions. An Executive Committee may be empowered by the Board to act between regular meetings, either permanently or on an ad hoc basis.

A list of all committees, their mandates and memberships, will be submitted to MFA upon their formation. In addition, MFA will be promptly notified of any changes in mandate or membership.

Permanent standing committees will be formed for oversight in areas of particular importance. Committees will be composed of three or more members and may include one member of senior management, except for the Audit Committee. Committees appointed will, at a minimum, include:

a. Audit Committee: Implements the Board's relationship with internal and external auditor(s). Recommends to the Board and hires, external auditor(s); responsible for engagement and any specific additional areas to be reviewed; reviews report for quality and findings. Findings of the annual external audit will always be presented by the auditor to the entire quorum of the Board. This committee also hires and oversees the internal auditor; approves audit plan; directs work; reviews reports; presents material findings to the Board.

In addition, the Audit committee reviews and presents to the Board reports from MFA examinations. On material adverse findings, the Audit Committee makes recommendations to the Board for action. This action does not prevent the MFA from presenting its findings directly to the Board if warranted.

b. Credit Committee: This committee is responsible for overseeing two related areas: 1) borrowings by primary mortgage lenders, and 2) mortgage loan standards. Risk management herein, is critical. As these areas become more complex and active, it might become necessary to divide the work between two separate committees. This committee:

> 1) Reviews and approves standards, as proposed by management, for evaluating applications for borrowings by primary mortgage lenders. Reviews and approves borrowings programs and offerings developed by management. Reviews and recommends to the Board for its approval, borrowing applications from primary mortgage lenders.
>
> 2) Reviews and approves guidelines and requirements, as proposed by management, for mortgage loans a) to be used as security for borrowings, or b) to be purchased in exchange for issuance of mortgage-backed securities. Guidelines should include: i) interest rate, loan-to-value ratio maximums, and other loan terms; ii) credit underwriting standards and documentation, iii) real estate appraisal standards and documentation, iv) model legal documents and other loan file documentation, and v) other matters bearing on adequate security for transactions (loan or purchase). Monitors implementation of guidelines through review of relevant information from reports from the Facility's management information system, internal auditor, external auditor, and the MFA.

c. Risk Management Committee: Reviews and assesses the risk profile of the Facility's assets and operations, and reports quarterly to the Board, providing recommendations for mitigating risk areas. Risks reviewed on a regular basis should at a minimum include credit, interest rate (market), liquidity, foreign exchange, business operations, and counterparty risks. Also, at the direction of the Board or on its own initiative this committee reviews, assesses, and makes recommendations concerning any significant problem affecting the Facility as it arises.

d. Secondary Markets Committee (Phase II): This committee should be formed at some reasonable time before the Facility begins to issue bonds. The committee will review bond market activity and pricing, report on outstanding bonds and other instruments, propose bond issues, including price, terms, timing of issues, and other relevant matters, and report to the Board on market conditions and proposed and executed issues, and relevant ratings.

These committees shall meet as necessary to perform their duties, but no less than quarterly. Minutes of such meetings will describe significant items discussed and include any committee decisions. Decisions of these committees will be submitted to the Board for ratification.

E. Senior Management

For key senior management positions, including those following, MFA requires submission of a complete curriculum vita of professional work experience and education on any candidate before hiring. MFA reserves the right to disapprove in its sole judgment, any candidate based on significant factors pertaining to character or competency.

A Chief Executive Officer (CEO), or managing director, will be appointed by the Board and will be responsible to the Board for the day-to-day operations of the Facility, for strategic planning, for presenting to the Board proposals on material issues, and such other duties as may be designated by the Board. The CEO will be a full-time position with adequate professional compensation. The CEO will not be a member of the Board. *[may contradict business plan]

Qualifications for the CEO would typically include several years of senior management experience in banking or other financial services, and education to at least a bachelor's degree level in business curricula. Recent responsibilities would be commensurate with those in the Facility.

As the operations of the Facility grow in size and complexity, it may be necessary to hire additional senior management. The creation of these positions and the hiring of individual candidates would be recommended by the CEO and approved by the Board. These positions would normally report directly to the CEO. Such positions could include:

A Chief Lending Officer (CLO), or head of credit, whose responsibilities would include developing credit policies and procedures, developing programs for borrowings by primary mortgage lenders, establishing credit standards for underwriting and documenting mortgage loans securing borrowings, and implementing credit standards and evaluating such mortgage loans. Phase II duties will include establishing credit policies and standards for loans to be purchased for resale or to secure bond issues.

Qualifications for CLO would typically include several years of management experience in lending in banks or other financial services and education to at least a bachelor's degree level in business curricula.

A Chief Financial Officer (CFO), or head of treasury, whose responsibilities would include treasury functions, asset/liability management, capital adequacy, liquidity and cash flow planning, accounting, Information Technology (IT) systems, and financial reporting and management information systems. In Phase II, CFO responsibilities would be expanded to include pricing and terms of bond issues, and implementation of sophisticated asset/liability and capital models and stress-testing.

Qualifications for CFO would typically include several years of management experience in accounting and finance in banks or other financial services and education to at least a bachelor's degree level in business curricula. Recent responsibilities would be commensurate with the difficulty and technical level expected in work for the Facility.

General Counsel, an attorney with financial intermediary expertise whose duties would include drafting or approval of Facility contracts, model forms, and other legal documents; report to and advise management and the Board on emerging legal issues of importance; hiring and oversight of law firms or attorneys where necessary for specialized legal work; overseeing Facility litigation; and providing such other legal advice or service required by management and the Board. During an initial start-up period, these functions may be contracted and performed by counsel external to the Facility.

Qualifications for General Counsel would typically include an active license to practice law in Egypt; several years of experience in the practice of financial and banking law and contracts, and a degree in law from an accredited university.

F. Other officers and professional staff

Staffing is a key responsibility of the Board and senior management. Organizational structure, job descriptions, and staffing will be maintained in response to the size and complexity of operations. The initial number of positions should be minimal, though adequate, and new job positions will be filled only to the extent necessary for effective operations. Candidates hired for positions must clearly fulfill education and experience requirements for the particular job description. Personnel policies and procedures will conform to Egyptian laws and regulations.

G. Compensation

Fees, salaries, bonuses, benefits, and other forms of compensation set for Board members, senior management, and other officers and employees shall be reasonable, commensurate with duties and responsibilities, and consistent with the long-term goals of the Facility. Any such compensation program shall not focus solely on earnings performance, but shall take into account risk management, operational stability, and legal and regulatory compliance as well, and shall be undertaken in a manner that complies with applicable laws, rules, and regulations.

H. Ethical Conduct and Potential for Conflicts of Interest and Self-dealing

Members of the Board and senior management must avoid all instances of conflicts of interest or self-dealing, as well as their potential or appearance. They must not take any action which would result in their personal financial benefit other than normal and just compensation from the Facility. Nor can they bestow favors or benefits of any amount to any primary mortgage lender or its officers, directors, employees, parent owners or other affiliates.

If a conflict or potential conflict arises or is discovered, the affected person must, at a minimum, immediately notify 1) the Chairman of the Board, if such person is a director or CEO, or 2) the CEO, who will notify the Chairman, if such person is an officer or other employee. The Chairman will notify other Board members and include the situation on the agenda of the next Board meeting. If the situation is material and time is critical to its resolution, the Chairman may call a special Board meeting. The Board will seek further information and may, depending on the nature of the instance, initiate a formal investigation.

The affected person must also recuse himself from any decision relating to this or any conflict of interest, until it is resolved.

The Facility will immediately report such conflict or potential conflict of interest situations in writing to the MFA, including all important facts and steps being taken to investigate and resolve.

Appointment of Board members and hiring of officers will include an investigation for criminal activity, arrest warrants, or ethical sanctions or problems related to financial institutions. Prior to appointment, Board members and senior officers must sign a sworn statement that no such conditions exist, to their knowledge. Such requirements may be waived if such procedures have already taken place due to licensing by the Central Bank or the MFA.

In its written personnel policies, the Facility will set standards for ethical conduct, so far as it pertains to their professional duties, for all Board members, officers, and employees.

Disclosures of Close Business Relationships. In the ordinary course of business, and in addition to specific borrowings or loan purchase transactions, the Facility may need to engage services of, or otherwise do business with, shareholder institutions or their affiliates. Such services or products may include establishing checking or deposit accounts, establishing of credit lines, subcontracting of information technology, purchasing insurance coverage, renting office space, legal consultation, or other similar transactions. In order to prevent conflicts of interest or their appearance, such relationships should be fully disclosed to the Board and, if possible, should be approved in advance. The internal auditor shall regularly review such existing relationships and report on them to the entire Board.

Additionally, the Facility will promptly report in writing such close business relationships to the MFA, including a certified copy of a Board minutes excerpt in which such relationship was discussed and approved.

I. Internal Auditor

This position is responsible to the Board and will report quarterly, or more often as necessary. Internal auditing is an ongoing function and includes review and evaluation of all key operational areas.

Duties include review, evaluation, and reporting on effective implementation and reliability of records, controls, and systems, including: accounting records, transaction entries and records, IT control systems, security of financial and physical assets, and file documentation for loans either purchased or taken as security. The internal auditor will normally review these items on a sample basis, though material items may be reviewed comprehensively.

Annually, the internal auditor must submit an audit plan to the Board for its approval. Such a plan should be updated periodically and compared with actual activities performed.

The person fulfilling this position must have a demonstrated experience and expertise in accounting, auditing, and/or management information systems, with preference for experience in financial institutions.

During the early stages of operation when there is little financial activity, this position may be contracted in order to control expenses. The contracted firm or individual must have no affiliation with the Facility or its external auditor.

See also the Safety and Soundness section of this regulation regarding duties of the internal auditor.

J. Compliance Function

The purpose of this organizational function is the ongoing monitoring of the Facility's degree of compliance with relevant laws and regulations, as well as its own policies and procedures. This function will report regularly to the Board. This function may need to consult from time to time with the Facility's General Counsel, or in extraordinary instances, outside attorneys or other legal specialists. Initially, this function could be performed by the internal auditor.

K. External Audit

The Board will propose to the Annual General Assembly meeting a reputable and qualified audit firm to produce an audit report, in accordance with Egyptians Standards on Audit. Egyptian law requires annual audits by two separate audit firms registered at MFA.

Audit report(s) should, as a minimum, include an audit report on the financial statements and a management letter on internal control. The audit report will render an opinion as to whether the financial statements fairly represent the Facility's financial condition. The management letter will address all material types of risk commensurate with the Facility's size and complexity of operations.

The external audit firm must be changed after three consecutive years. The Facility may change the audit firm more often, but the Board must report in writing to MFA and other regulatory authorities whether such change was due to adverse audit results.

All audit reports required by other relevant regulators, such as the Capital Market Authority, will also simultaneously be submitted to MFA.

See also the Safety and Soundness section of this regulation regarding duties of the internal auditor.

L. Information Technology

The information technology function must have sufficient systems and personnel to fulfill the present and contemplated near-term future needs of the Facility. The IT function must be able to support the accounting system and provide regular reports sufficient for monitoring by management and decision support. The system must have adequate controls to preserve the integrity and reliability of data. As part of a disaster recovery plan, adequate back-up systems and procedures and off-site storage must be maintained. Adequate written policies and procedures must be developed and maintained to ensure such standards are met.

M. Internal Control System

The Facility's organizational structure, functions, lines of authority, separation of job responsibilities, flow of work processes, and lines of communication should be designed and maintained to minimize errors and losses, and to prevent and identify fraud. The status and effectiveness of internal controls will be reviewed, evaluated, and reported by the internal and external auditors, and by MFA examinations. See the Safety and Soundness section of this regulation for further information.

N. Regulation by Mortgage Finance Authority

The Facility will be subject to regular examinations by the MFA and will be required to submit periodic reports on various financial and operational areas.

The examination reports will be strictly confidential, with results disseminated only to the Facility, including its Board and senior management, the external auditor, and MFA. By mutual agreement between the Facility and MFA, the report may be disseminated to other significant stakeholders.

The Board of the Facility will be responsible for reviewing the examination report and responding in a timely manner to all adverse findings.

Section II. Capital Adequacy

A. Scope and Purpose

This section more closely defines the minimum standards of capital and minimum standards for creating, implementing, and maintaining the Egyptian Liquidity Facility's program for managing capital. Capital represents the investors' interest in the Facility and provides capability for absorbing losses. Managing capital levels is one of the most important components of risk management for the Facility. Capital can be built up through the retention of earnings and through additional issue of capital stock.

The Board and senior management are responsible for ensuring that adequate capital is maintained according to regulatory requirements and the risk profile of the Facility's balance sheet and operations. In fulfilling its duties, the Board should adopt a program, as a part of its business plan, for maintaining adequate capital under current operations and according to expected future requirements. Such a program should forecast, and have a plan for fulfilling, capital needs for at least three years. Such a program should take into account growth, sources and uses of funds, and market interest rates. Such a program should identify any additional sources of capital, if required. Additionally, the Board should review capital adequacy at least quarterly from financial reports presented by senior management or committees at its regular meetings.

Requirements discussed herein pertain to Phase I of the Facility operations. During Phase II operations, risk management will become more complex, and other requirements, whether substitute or additional, will be developed for capital standards. These requirements will likely include an internal risk-based model approach, as described in Basel II Accords, and will require more sophisticated IT systems for implementation.

B. Regulatory Capital Requirement

<u>Initial Capital</u>. The Facility's initial capital in the form of stock issued and paid-in capital will be no less than one hundred million Egyptian Pounds (LE 100,000,000). Though the organization may be legally formed prior to this capital investment, no lending or other significant business operations may begin until such investment is received.

The capital requirement will include two risk-based ratios, one for Tier One capital and another for Net capital.

Risk-based <u>Tier One Capital Requirement</u> will be a minimum ratio, the numerator of which is qualifying Tier One, or core, regulatory capital as defined herein, and the denominator of which is total risk-weighted assets, as defined herein.

Risk-based <u>Total Capital Requirement</u> will be a minimum ratio, the numerator of which is qualifying regulatory Total Capital as defined herein, and the denominator of which is total risk-weighted assets, as defined herein.

Initially, the Tier One capital requirement is **4.0%**, and the Total capital requirement is **8.0%**. The Facility will be in compliance if it meets or exceeds <u>either</u> of these requirements.

These ratios may be modified from time to time by the MFA. An adequate transition period will be allowed to meet more stringent requirements.

C. Qualifying Regulatory Capital

The regulatory Total capital of the facility represents the amount of Tier One, or core, capital plus Tier Two, or additional capital.

Tier One, or core, capital of the Facility includes:

1. The par or stated value of outstanding perpetual, voting stock (typically known as common stock), issued for cash payment;
2. Shareholders' Reserves and other additional paid-in capital;
3. Retained earnings (accumulated losses) from prior years; and
4. Fiscal year-to-date net profit (loss).

Tier Two, or additional, capital of the Facility consists of:

1. The Facility's general loan-loss reserves, which have established and maintained for covering losses for loans and other assets which would be classified as performing, with no material weaknesses, up to an amount no greater than 1% of such assets' value

2. Unrecognized profits (losses) resulting from revaluation at fair value for any available-for-sale investments.

3. Subordinated debt, in loans or bonds, if the following conditions are satisfied:
    a. the Facility provided a written agreement with the MFA including the subordinated debt in the calculation of Additional capital;
    b. the funds are completely used;
    c. the Facility did not give the creditor instruments for insuring the collection of payments based on the above and that it does not have a status of an insured debt;
    d. the Facility does not have an offsetting or converse agreement or other arrangement with the creditor which is essentially the same operation, but in the opposite direction;
    e. in the loan agreement the maturity date is set for at least five years, and it can not be repaid upon the maturity date if that operation will decrease Facility's capital below the required level;
    f. the subordinated debt of the Facility must be regularly repaid in accordance with agreed terms;
    g. the debt can not be repaid or amortized before the maturity date without the previous approval of the MFA in written form; and
    h. the debt, in the event of Facility's liquidation, is in subordinate position in relation to other liabilities.

Subordinated debt counted toward Tier Two capital will in no case exceed 50% of Tier One, or core, capital.

4. Hybrid items, including convertible instruments of capital, with previous written agreement of the MFA for the inclusion of those instruments in the Tier Two capital of the Facility.

D. Risk-weighted Assets

Risk-weighted assets of the Facility represent assets of the balance sheet and commitments and other such off-balance-sheet obligations and which have been multiplied by the appropriate rate denoting the risk exposure of such assets. Account definitions will be those used under accepted international or Egyptian accounting principles. Account balances used in such calculations should be net of specific loss allowances, unearned interest, depreciation, or other such deduction or exclusion, according to such accepted accounting principles.

Groups of assets and off-balance-sheet items are risk-weighted as follows:

1. Cash and deposit funds, including:
   - Cash in Egyptian currency held in vault by the Facility;
   - Deposits, which are available within twenty-four (24) hours of notice, in commercial banks licensed by the Central Bank of Egypt.

Risk weighting for these assets is **0%**

2. Liquid assets and investments, including:
   - Deposits, not available within twenty-four (24) hours but with a maturity of less than one year, in commercial banks licensed by the Central Bank of Egypt;
   - Obligations, in the form of notes or bonds whose terms to maturity are three years or less, of the government of Egypt; and
   - Any other investments qualifying as liquid under law, regulation, or other MFA directive, pertaining to the Facility.

Risk weighting for these assets is **20%**

3. Other defined non-liquid claims and investments:
   - All other deposits in banks or other financial institutions, with a term to maturity of five years or less;
   - Borrowings granted by the Facility to banks or mortgage finance companies within Egypt, which are secured by allowable mortgage loans and otherwise in compliance with Facility policies and relevant laws and regulations;
   - All outstanding commitments to grant borrowings to, or to purchase loans from, mortgage finance companies or banks; and
   - Any other deposits or investments which would qualify as liquid under law, regulation, or other MFA directive, pertaining to the Facility, except for their remaining term to maturity.

Risk weighting for these assets is **50%**

4. All other risk-based assets:
   - All other assets and all other off-balance-sheet items.

Risk weighting for these assets is **100%**

Total risk-weighted assets is the summation of the products from multiplying each asset or group of assets times its corresponding risk weighting factor.

E. Reporting and Monitoring

In fulfilling its duties, the Board should review the Facility's capital adequacy and especially its regulatory capital ratios at least quarterly and take any necessary action to ensure its compliance.

The Facility is obliged to report to the MFA on a quarterly basis on the condition and structure of its capital using a form prescribed by the MFA, no later than 15 calendar days after the previous reporting cycle.

Apart from this obligation, important changes in capital and potential negative changes for the calculation of the adequacy of capital shall be reported by the Facility verbally, and in writing, immediately upon their discovery and confirmation by the Facility.

Two authorized persons who represent the Facility shall sign the report.

The prescribed integral parts of report of the Facility are the following: a) proof of compliance and evidence that it has been ratified by the Facility's Board; b) confirmation by the Facility's internal auditor that the report is complete and accurate; and c) contact persons' names and telephone numbers.

The Facility's capital position shall also be evaluated annually at the end of its fiscal year by its external auditors, and their report must give information on the following:
1) whether the reporting system of the Facility offers correct information about the adequacy of capital;
2) whether information on the adequacy of capital, contained in the Facility's report as of the end of the reporting year is correct, taking into the consideration the quality of the Facility's asset portfolio and other relative risk categories.

Section III. Safety and Soundness Standards

A. Purpose and Scope

This section of the regulation addresses safety and soundness issues pertaining to the operations of the Facility. The MFA in its regulation of the Facility will take into account the guidelines and provisions set out herein.

B. Risk Management Systems

In the course of its business, the Facility will be subject to typical financial institution risks, which include credit, interest rate (market), liquidity, foreign exchange, business operations, and counterpart risks. In order to promote safety and soundness in Facility operations, the Board and senior management will establish various methods and systems for identifying, monitoring, measuring, and controlling different forms of risk. Some important examples and guidelines for management and implementation are presented following.

<u>Policies and Procedures</u>
The Board and senior management should manage the Facility by the establishment of effective policies and procedures for each major operational area. Generally, policies and procedures for each area should:

1) be approved by Board
2) be in writing and distributed or available to all relevant affected personnel, whether in hard copy or electronically
3) be reviewed and updated from time to time; the published copy should show date of last approval/edition
4) clearly state subject and describe the purpose and scope
5) set out authority and responsibility for implementation
6) set objectives for performance
7) set, recommend, and/or explain detailed means for achieving objectives;
8) contain additional relevant technical information, in the main body or appendices, or give accessible references for such information
9) provide for performance monitoring, including performance objectives, documentation of activities, and management reports; and
10) otherwise be of form and content that is clear and useful to those responsible for implementation.

<u>Internal Controls</u>
The Facility should maintain and implement an internal control structure sufficient for the nature, scope, and risk of its business activities that provides for:

1) An organizational structure and job descriptions that clearly set out: a) positions for management, employees, consultants and contractors; b) assignments of authority and responsibility, as well as lines of communication; and c) provisions for accountability and monitoring.
2) Policies and procedures adequate to safeguard assets and to prevent errors and fraud; such measures will include assignment of levels of approval authorities and dual control over key assets; consideration should be given to separating front office investment activity from back office operations.
3) Compliance with applicable laws, regulations and policies.

<u>Internal and External Audits</u>
The Facility must establish and implement internal and external audit programs that provide for:

1) A continuous internal audit function that addresses all operational, compliance, and risk areas; such work should be according to an annual audit plan approved by the Board and updated as necessary; during its initial stages of lower business activity the Facility may contract this function externally as necessary;
2) Two external audits performed at least annually by independent and qualified audit firms in conformity with Egyptian audit and accounting standards and Egyptian laws
3) Adequate management oversight from the level of the Board, through an active Audit Committee and other means, for a) establishing guidelines, standards, and objectives for audit functions, b) ensuring compliance with international audit and financial reporting standards, and Egyptian accounting standards and law, and c) reviewing audit report findings and making responsive recommendations;
4) Adequate monitoring of internal control based on the Facility's size, structure and scope of operations; the annual external audits should provide a report on internal control;
5) Independence of the audit functions; reports should be provided directly to the Board and/or the Board-appointed Audit Committee; hiring of auditors should be performed or recommended by the Audit Committee and ratified or approved by the Board;
6) Qualified professionals for undertaking of audit functions;
7) Adequate testing and review of audited areas together with adequate documentation of findings and of any recommendations and corrective actions; and
8) Verification and review of measures undertaken to address and correct identified material weaknesses.

<u>Information Technology, Accounting Systems, and Management Information and Decision Support</u>

The Facility should establish and implement information technology and accounting and reporting systems sufficient to accomplish the following:

1) To ensure that its proprietary and non-public information and data are protected from access by unauthorized users, and otherwise protected by adequate security measures, including an ability to effect timely recovery and resume operations after a disaster or reasonably foreseeable adverse event;
2) To ensure that data are reliable, accurate and available at all times as needed for its business operations;
3) To include comprehensive information about particular transactions and business operations, particularly loan servicing, including payments received and delinquencies;
4) To enable the Board and its committees to make informed decisions and to exercise its oversight function, by providing all such relevant information of an adequate but not unnecessary level of detail;
5) To enable the Facility's management at all levels to make informed decisions and to assess risks for all business activities on an ongoing basis; and
6) To ensure timely and complete submissions of reports of financial condition and operations to the Board, senior management, and other stakeholders, including any periodic reports and special reports required by MFA or other regulators.

<u>Legal Documents</u>

Major risk areas where effective legal documents are important for managing risk are: 1) borrowings granted from the Facility to primary mortgage lenders; and 2) loan documentation for loans securing such borrowings.

Additional risk areas emerging during Phase II operations will include: 1) transactions for the purchase of loans by Facility from primary mortgage lenders; 2) loan documentation on loans purchased; 3) issuance of mortgage-backed bonds or other securities; and 4) quality of loan portfolios.

The Facility's General Counsel is responsible to its Board for ensuring adequate legal documentation for all such transactions. Form, terms, and conditions of legal documents should protect the rights and interests of the Facility and should contain no provisions which would be misleading to the parties. The General Counsel is also responsible for oversight and approval of any such documents developed by other qualified legal counsel. The Board is ultimately responsible for approval of all such forms, documents, and transactions. All such documents must conform to Egyptian law and any relevant regulations. See also Standards for Mortgage Loans.

C. Eligibility of Mortgage Lenders to Borrow from the Facility

General Eligibility: The following types of organization, which are primary mortgage lenders, are qualified to borrow from the Facility:

1) Mortgage finance companies licensed by the MFA; and
2) Commercial banks licensed by the Central Bank of Egypt.

This basic eligibility is granted by virtue of such license and requires no further action by these primary mortgage lenders.

Suspension and Return to Eligibility: The eligibility of a mortgage finance company for obtaining borrowings or renewals from the Facility may be suspended for the following reasons:

1) The capital level of the mortgage finance company falls below a level required in law or regulation or is deemed inadequate by the Facility;
2) The most recent on-site examination by MFA reports significant adverse information in the operations or lending of the mortgage finance company;
3) The most recent external audit reports significant adverse information in the operations or lending of the mortgage finance company; or
4) The Facility at any time becomes aware of such significant adverse information.

The eligibility of a commercial bank for obtaining borrowings or renewals from the Facility may be suspended for the following reasons:

1) The capital level of the commercial bank falls below the level required in law or regulation or is deemed inadequate by the Facility;
2) The most recent on-site examination by the Central Bank reports significant adverse information in the operations or lending of the commercial bank;
3) The most recent external audit reports significant adverse information in the operations or lending of the commercial bank;
4) The Facility at any time becomes aware of such significant adverse information; or
5) The commercial bank exceeds its regulatory limit for mortgage lending according to the judgment and findings of the Central Bank.

Such suspension may be cancelled and the lender returned to eligibility at any time, by the Facility at its sole discretion if its Board after due review and deliberation determines that reasons for such suspension have been corrected.

D. Evaluation and Approval of Borrowings to Mortgage Lenders

The Facility will in its sole discretion approve or deny applications for borrowings from mortgage lenders, after taking into account all relevant criteria. The Facility will, however, make every effort to use criteria and procedures that are transparent and fair. The Facility's

Board is responsible for ensuring that any approval or denial of a lender's borrowing application is not influenced by patronage, political favors, or other corrupt practices.

All borrowings or renewals or modifications of existing borrowings must be approved by the Facility's Board, or by its Executive Committee with later Board ratification. The Facility's Board will establish guidelines for any such delegation of its approval authority.

The Facility will develop, approve, and publish from time to time, its criteria for borrowings offered, which will include:

- The interest rate, required level of collateralization, timing and amounts of repayment, provisions for recourse or collateral replacement, and other terms and conditions. At a given time, different interest rates may be offered with differing terms and conditions.

<u>Applications for borrowing</u>: A primary mortgage lender must apply for each borrowing by submitting a written application package. Such application package shall at a minimum include:

1) Application form designed or approved by the Facility; such application form will include name of primary mortgage lender, date of application, proposed date(s) of funds disbursement, borrowing amount, disbursement amounts and timings if more than one, proposed interest rate, and other terms and conditions of repayment;
2) Certified copy of minutes showing approval of this application by the primary mortgage lender's Board;
3) List of mortgage loans offered as security with principal balances and other relevant terms and conditions; total of principal balances must be sufficient for collateral requirements;
4) If not already on file with the Facility, the most recent external audit report by external auditor;
5) If not already on file with the Facility, the most recent examination report by MFA or Central Bank;
6) Internal financial statement, as of most recent month-end, including Statement of Condition (balance sheet) and Statement of Operations (income statement), as prepared for mortgage lender Board or as prepared and submitted to MFA or Central Bank of Egypt;
7) Lending plan – For mortgage loans to be offered by lender with borrowed funds, proposed interest rate, maturity, and terms and conditions to be offered (some of these data may be expressed as ranges); anticipated period of disbursement of loan funds; any other material information on such loans; and
8) Such other information as the Facility may require from time to time.

<u>Commitments and Interim Period Market Risk</u>: The Facility may, according to the application of the primary mortgage lender, approve a commitment for a borrowing whose amounts will be drawn down later or over a period of time. Interest rates and other terms for such borrowings will be set at time of disbursement according to an agreed-upon disbursement plan. A formula for determining the interest rate may be negotiated in advance. The Facility will have the right to charge a negotiated fee for funds not drawn down, as compensation for its costs in keeping funds available. Any and all such terms and conditions are subject to negotiation and agreement between the Facility and primary mortgage lender. The provisions of this paragraph and other parts of this regulation are not intended to limit or encumber such negotiations but rather to ensure that the Facility manages its risk and operates in a safe and sound manner.

<u>Collateral for Borrowings</u>: During Phase I, primary mortgage lenders will assign specific mortgage loans as security for their borrowings from the Facility. Legal documents for the borrowing will set out criteria and conditions for transfer of such mortgage loans to the

Facility in the event of borrowing default by the primary mortgage lender. In order to protect its interest, the Facility will typically require: 1) over-collateralization – the assignment of mortgage loans whose outstanding principal balance in the aggregate totals some specified amount exceeding 100% of the borrowing amount; 2) full recourse – the requirement that mortgage loans 90 days or more delinquent be automatically replaced with cash or equivalent mortgage loans of the same or greater outstanding balance whose payments are current; or 3) some combination of these preceding. Primary mortgage lenders must report monthly on such loan performance and must maintain accounting systems adequate to produce such reports reliably.

Loan Administration and Servicing: In the normal course of business, the primary mortgage lender will retain ownership, as well as rights and obligations for servicing of mortgage loans securing such borrowings. Any such servicing entity must maintain adequate staffing and reporting systems to ensure effective loan administration, including collections and other treatment of non-performing loans. As a part of its general powers in evaluating eligibility, the Facility will from time to time evaluate the primary mortgage lender's loan administration and servicing functions.

Discretionary powers: Due to limitations of funds available and limitations on the speed with which borrowings can be granted and disbursed, the Facility may from time to time limit the borrowings it grants, either generally or to only the most qualified primary mortgage lenders.

E. Standards for Mortgage Loans

The Facility will set standards of quality for 1) mortgage loans to be submitted as collateral securing borrowings granted primary mortgage lenders, and 2) mortgage loans to be purchased to secure bonds and other instruments issued by the facility. Standards for both types of mortgage loan purposes will be similar or the same, though standards may be revised from time to time by the Facility.

The Facility will accept only mortgage loans meeting specified standards of quality, including:

1) Those allowed under Egyptian real estate finance law and its executive regulations
2) Those allowed by the MFA according to its circulars, memos, and other published information, as well as those subject to any supervisory restrictions that may have been imposed upon a particular mortgage finance company
3) Other specific standards and limitations that may be generally established or revised by the Facility from time to time, or set for particular loan packages.

Mortgage Loan Documentation: As evidence that these standards are met by loans submitted by mortgage finance companies, the following minimum loan file documentation is required for each and every loan:

Legal documents: In order to protect its interest in mortgage loans purchased or accepted as security, the Facility will require certain provisions and conditions for mortgage loan documents to be used by primary mortgage lenders, and the Facility may recommend or require certain model document forms to be used, such as the MFA-approved model mortgage contract.

All legal documents pertaining to mortgage loans should be drawn up or approved by the Facility's General Counsel to ensure that they conform to the Egyptian law and any relevant regulations.

Loan application: Minimum documentary standards include: adequate borrower information and identification; signed by all borrowers and guarantors; property identification and basic information; loan purpose; and loan amount, rate and other terms applied for.

Loan approval: Signed by lender's designated approval authority, date of approval, loan information, including amount, rate, term, and other terms and conditions.

Other documents: In form and content as required by the Facility; including payments, payments disclosures, and property insurance.

Borrower credit-worthiness: Adequate borrower identification, adequate financial and other information on all borrowers and guarantors, borrower income, cash and savings, current borrower debt, verifications of borrower income and deposits, borrower credit history from Central Bank, lender investigation, and/or credit bureau, and payment history on this loan if any.

Appraisal reports: The Facility will specify uniform standards for appraisal reports, which will generally conform to such standards as Uniform Standards of Professional Appraisal Practice (USPAP) or International Valuation Standards (IVS). The Facility may design a preferred Uniform Residential Appraisal Report Form (URAR) for use by primary mortgage lenders or accept such form as designed by the association of real estate appraisers. The appraisal process should include an adequate survey and analysis of market sales and rental data.

In order to provide sufficient information for decision by loan approval authority, appraisal reports should at a minimum include: an adequate property description; a statement of the property's highest and best use; three approaches to estimating value, including cost, sales comparison, and income approaches, with explanations for omission of any approach; data on improved comparable property sales, land sales, and rent comparables where available and relevant; adequate support and demonstrated logic for conclusions of value; a final reconciliation and value estimate or opinion; designation of value type, such as "as is," "as if completed," "prospective future value"; effective date of appraisal; appraiser identification and qualifications; appraiser's certification, including whether inspected; assumptions and limiting conditions; and a discussion of any other material conditions affecting value.

F. Financial Operations

General Considerations: Earnings are the result of market forces, pricing, cost of funds, asset/liability management, control of operating expenses, and risk management. The goals of earnings are to provide an adequate return to the investor and to accumulate capital sufficient to support growth, to absorb losses, and to meet regulatory capital requirements. The level, trend, and quality of earnings are all criteria in evaluating profitability, and such earnings must be attained within a framework of safe and sound operations. The Facility's Board and senior management are responsible for establishing and maintaining successful financial operations and risk management. In striving for these goals, the Facility should adhere to the following minimum guidelines.

Financial Reporting: Accounting and information systems of the Facility must be adequate to provide a regular Statement of Condition (balance sheet) and Statement of Operations (income statement) and such other financial reports on all phases of operations sufficient for the Board and management to fulfill its obligations. Such systems must also be adequate to allow an annual external audit with an unqualified opinion as to financial statement representation. In addition, the Facility will be required to submit periodic financial reports to the MFA in such form and content as will be determined by the Authority.

Business Plan and Budget: On at least an annual basis, the Board will review and approve a business plan and budget for at least the following one-year period. The business plan will include 1) a statement of management's intended objectives and strategy for the coming period; 2) forecast Statements of Condition and Operations on at least a quarterly basis, accompanied by supporting assumptions such as interest rates on loans and investments, cost of funds, and operating expenses; and 3) cash flow statements showing growth and sources and uses of funds. A detailed budget forecasting operating expenses should also be prepared for the same period. Forecast performance will be compared with actual on at least a quarterly basis.

Asset/Liability Management: On an on-going basis management must manage its sources and uses of funds and their interest rates to produce profitability and to maintain adequate liquidity, while controlling market risk. The Facility should establish and implement policies and procedures to identify, measure, monitor, and manage market risk effectively. Market risk is usually considered to be composed of interest rate risk and liquidity risk. Interest rate risk is defined as potential for losses in value and/or income from changes in market interest rates. Liquidity risk is the potential for an impairment of ability to meet short-term liabilities as they come due (illiquidity), resulting from a mismatch in maturities of assets and liabilities. Interest rate risk can arise from a mismatching of asset and liability rates and re-pricing options, and liquidity risk can arise from mismatching maturities of assets and liabilities.

The methods and level of technology used in the Facility's program of asset/liability management should be commensurate with the complexity of the Facility's financial operations and its areas of risk concentration. Information technology should be sufficient to produce forecasts and models which are correct based on assumptions and to compare such models with actual performance on an ongoing basis.

Adequate policies and procedures for asset/ liability management should include:

1) The ability to quantify and monitor interest rate risk effectively and to model the effect of differing interest rate scenarios on the Facility's financial condition and operations;
2) The development of risk management strategies that respond effectively to expected or probable changes in interest rates;
3) The ability to quantify and monitor the Facility's liquidity effectively, and to identify and anticipate various likely market environments and their effects on liquidity; and
4) The establishment and maintenance of an effective contingency plan for liquidity under various scenarios, including interim credit capacity, asset sales, and other effective alternatives.

Management of Balance Sheet Growth: Excessive or uncontrolled growth can adversely affect many aspects of Facility operations. The growth of the Facility's balance sheet should be managed prudently and take into account:

1) The source and volatility of funds that support balance sheet growth;
2) The use or intended use of such funds, taking into account the various risk factors including credit risk and the matching of interest rates and maturities of sources and uses (market risk);
3) Any changes in credit risk or interest rate risk resulting from balance sheet growth
4) The effect of balance sheet growth on the Facility's capital adequacy; and
5) Revisions or additions to policies and procedures needed to manage changes in risk that may occur as a result of balance sheet growth.

Dividend Policy: At a meeting for which an acceptable audited report on fiscal-year-end financial operations is available, the Board may vote to approve a distribution of dividends to shareholders. Dividends may only be paid after sufficient earnings have been retained for meeting regulatory capital requirements and the Facility's business plan. Dividends will be prevented or reduced to offset prior period downward adjustments in earnings, such as may be caused by external audit adjustments or an increase in loss reserves required by a regulatory authority. Dividends also should not be paid if asset growth planned for the coming year is likely to cause capital to be insufficient to meet its required ratio or level. No dividends will be paid immediately following a year of net loss, even if capital requirements have been met.

Additional Phase II Requirements: Upon entry of the Facility into Phase II of its operations, the complexity of market and operational risks will likely increase substantially, and policies and procedures and systems support should be revised commensurate with such change.

G. Liquidity and Funds Management

The Facility must maintain a liquidity position sufficient to meet immediate contingencies and should manage its cash and liquid investments adequately to ensure fulfilling its commitments, expenses, and other short-term obligations. Liquid investments should be managed to provide adequate interest income, protection against loss in value, and accessibility for fulfilling cash flow needs. Accessible credit lines for additional capacity for meeting short-term funding needs should also be established.

Adequate operating accounts must be maintained with commercial banks for necessary transactions clearing. See comments on Disclosure of Close Business Relationships in Corporate Governance section.

Eligible Liquid Investments: The following are eligible for inclusion in liquidity to meet criteria of this section:

- Deposits with a remaining term to maturity of one year or less in commercial banks licensed by the Central Bank of Egypt;
- Obligations, in the form of notes or bonds with a remaining term to maturity of three years or less, of the government of Egypt or of the governments in the Organization for Economic Co-operation and Development (OECD). Any such investments should be readily saleable on available securities exchanges or other funds markets, with no significant penalties, transactions costs, or delays. No investments should be held which have adverse or below-investment-grade ratings by any of the recognized international ratings organizations.

Short-term Liabilities: For purposes of calculating the Facility's liquidity requirement, the following must be included:

- All payments of principal and interest on any type outstanding debt or other liabilities which are due within one year;
- All outstanding commitments to fund borrowings within one year;
- All outstanding commitments to purchase loans within one year;
- All operating expenses due or expected to be due within one year according to the Facility's approved budget; and
- Any other obligation to disburse funds within one year.

Minimum Liquidity Position: The daily liquidity ratio for the Facility is calculated at close of business each day by dividing cash and eligible liquid investments by short-term liabilities, as those items are defined herein. A minimum required daily liquidity ratio may be from time to time set by the MFA in its sole discretion, taking into account market conditions and risk management of the Facility and such other factors as it deems relevant. A reasonable transition period will be allowed when a more stringent requirement is set.

The MFA may establish a regime of cash penalties for failure to maintain adequate liquidity.

Liquidity Reporting and Plan. As part of its asset/liability management, senior management of the Facility should at all times know the amounts and timings of its outstanding commitments and other obligations and have a plan for generating cash to meet those obligations on a timely basis in the normal course of business. Information systems should be capable of generating a daily report of all such known positions of sources and uses of funds and of likely contingencies.

Additional Phase II Requirements. When secondary market operations are undertaken information systems for reporting and cash flow management must additionally be able to take into account 1) funding of aggregate loan purchases, 2) meeting of bond payment obligations, and 3) receipt of payments on purchased loans.